treaty category. Accordingly, no portion of the stock of CFC1 is assigned to a treaty category under paragraph (a)(3) of this section.

(D) *Step 4*—(*1*) *General category stock.* The total value of the portion of the stock of CFC1 that is general category stock is $34,375x, which is equal to $25,000x (the value of the portion of the stock of CFC1 assigned to the subpart F income statutory grouping within the general category income statutory grouping) plus $9,375x (the value of the portion of the stock of CFC1 assigned to the specified foreign source general category gross income statutory grouping).

(*2*) *Passive category stock.* The total value of the portion of the stock of CFC1 that is passive category stock is $9,375x.

(*3*) *U.S. source category stock.* No value of the portion of the stock of CFC1 is U.S. source category stock.

(E) *Step 5*—(*1*) *General category stock.* All of the value of the general category gross tested income stock of CFC1 was assigned to the section 951A category in paragraph (c)(3)(ii)(B) of this section (Step 2). Accordingly, under paragraph (a)(5)(ii) of this section, the value of the stock of CFC1 assigned to the section 245A subgroup of general category stock is $9,375x, which is equal to the value of the portion assigned to the specified foreign source general category gross income statutory grouping. Under paragraph (a)(5)(v) of this section, the remainder of the general category stock of CFC1, $25,000x, is assigned to the non-section 245A subgroup of general category stock.

(*2*) *Passive category stock.* No portion of the passive category stock of CFC1 is in the foreign source gross tested income statutory grouping or the specified foreign source passive category gross income statutory grouping. Accordingly, under paragraph (a)(5)(iii) of this section, no value of the portion of the stock of CFC1 is assigned to the section 245A subgroup. Under paragraph (a)(5)(v) of this section, the passive category stock of CFC1, $9,375x, is assigned to the non-section 245A subgroup of passive category stock.

(*3*) *Section 951A category stock.* Under paragraph (a)(5)(v) of this section, all of the section 951A category stock, $56,250x, is assigned to the non-section 245A subgroup of section 951A category stock.

(F) *Summary.* For purposes of the allocation and apportionment of expenses, $56,250x of the stock of CFC1 is characterized as section 951A category stock, all of which is in the non-section 245A subgroup; $34,375x of the stock of CFC1 is characterized as general category stock, $9,375x of which is in the section 245A subgroup and $25,000x of which is in the non-section 245A subgroup; and $9,375x of the stock of CFC1 is characterized as passive category stock, all of which is in the non-section 245A subgroup.

(d) *Applicability dates.* This section applies for taxable years that both begin after December 31, 2017, and end on or after December 4, 2018.

[T.D. 9882, 84 FR 69070, Dec. 17, 2019]

§ 1.861–13T Transition rules for interest expenses (temporary regulations).

(a) *In general*—(1) *Optional application.* The rules of this section may be applied at the choice of a corporate taxpayer. In the case of an affiliated group, however, the choice must be made on a consistent basis for all members. Therefore, a corporate taxpayer (or affiliated group) may allocate and apportion its interest expense entirely on the basis of the rules contained in §§ 1.861–8T through 1.861–12T and without regard to the rules of this section. The choice is made on an annual basis and, thus, is not binding with respect to subsequent tax years.

(2) *Transition relief.* This section contains transitional rules that limit the application of the rules for allocating and apportioning interest expense of corporate taxpayers contained in §§ 1.861–8T through 1.861–12T, which are applicable in allocating and apportioning the interest expense of corporate taxpayers generally for taxable years beginning after 1986. Sections 1.861–9(d) (relating to individuals, estates, and certain trusts) and 1.861–9(e) (relating to partnerships) are effective for taxable years beginning after 1986. Thus, the taxpayers to whom those sections apply do not qualify for transition relief under this section.

(3) *Indebtedness defined.* For purposes of this section, the term ''indebtedness'' means any obligation or other evidence of indebtedness that qenerates an expense that constitutes interest expense within the meaning of § 1.861–9T(a). In the case of an obligation that does not bear interest initially, but becomes interest bearing with the lapse of time or upon the occurrence of an event, such obligation shall only be considered to constitute indebtedness when it first bears interest. Obligations that are outstanding as of November 16, 1985 shall only qualify for transition relief under this section if they bear interest-bearing as of that date. For this purpose, any obligation that has original issue discount within the meaning of section 1273(a)(1) of the Code shall be considered to be interest-bearing.

(4) *Exceptions.* The term ''indebtedness'' shall not include any obligation existing between affiliated corporations, as defined in § 1.861–llT(d). Moreover, the term ''indebtedness'' shall not include any obligation the interest on which is directly allocable under §§ 1.861–10T(b) and 1.861–10T(c). Under § 1.861–9T(b)(6)(iv)(B), certain interest expense is directly allocated to the gain derived from an appropriately identified financial product. When interest expense on a liability is reduced by such gain, the principal amount of such liability shall be reduced pro rata by the relative amount of interest expense that is directly allocated.

(b) *General phase-in*—(1) *In general.* In the case of each of the first three taxable years of the taxpayer beginning after December 31, 1986, the rules of §§ 1.861–8T through 1.861–12T shall not apply to interest expenses paid or accrued by the taxpayer during the taxable year with respect to an aggregate amount of indebtedness which does not exceed the general phase-in amount, as defined in paragraph (b)(2) of this section.

(2) *General phase-in amount defined.* Subject to the limitation imposed by paragraph (b)(3) of this section, the general phase-in amount means the amount which is the applicable percentage (determined under the following table) of the aggregate amount of indebtedness of the taxpayer outstanding on November 16, 1985:

Taxable year beginning after December 31, 1986	Percentage
First	75
Second	50
Third	25

(3) *Reductions in indebtedness.* The general phase-in amount shall not exceed the taxpayer's historic lowest month-end debt level taking into account all months after October 1985. However, for the taxable year ln which a taxpayer attains a new historic lowest month-end debt level (but not for subsequent taxable years), the general phase-in amount shall not exceed the average of month-end debt levels within that taxable year (without taking into account any increase in month-end debt levels occurring in such taxable Year after the new historic lowest month-end debt level is attained).

Example. X is a calendar year taxpayer that had $100 of indebtedness outstanding on November 16, 1985. X's month-end debt level remained $100 for all subsequent months until July 1987, when X's month-end debt level fell to $50. In computing transition relief for 1987, X's general phase-in amount cannot exceed $75 (900 divided by 12), which is the average of month-end debt levels in 1987. Assuming that X's month-end debt level for any subsequent month does not fall below $50, the limitation on its general phase-in amount for all taxable years after 1987 will be $50, its historic lowest month-end debt level after October 1985.

(c) *Nonapplication of the consolidation rule*—(1) *General rule.* In the case of each of the first five taxable years of the taxpayer beginning after December 31, 1986, the consolidation rule contained in § 1.861–11T(c) shall not apply to interest expenses paid or accrued by the taxpayer during the taxable year with respect to an aggregate amount of indebtedness which does not exceed the special phase-in amount, as defined in paragraph (c)(2) of this section.

(2) *Special phase-in amount.* The special phase-in amount is the sum of—

(i) The general phase-in amount,

(ii) The five-year phase-in amount, and

(iii) The four-year phase-in amount.

(3) *Five-year phase-in amount.* The five-year phase-in amount is the lesser of—

(i) The applicable percentage (the "unreduced percentage" in the following table) of the five-year debt amount, or

(ii) The applicable percentage (the "reduced percentage" in the following table) of the five-year debt amount reduced by paydowns (if any):

Transition year	Unreduced percentage	Reduced percentage
Year 1	8⅓	10
Year 2	16⅔	25
Year 3	25	50
Year 4	33⅓	100
Year 5	16⅔	100

(4) *Four-year phase-in amount.* The four-year phase-in amount is the lesser of—

(i) The applicable percentage (the "unreduced percentage" in the following table) of the four-year debt amount, or

(ii) The applicable percentage (the "reduced percentage" in the following table) of the four-year debt amount reduced by paydowns (if any) to the extent that such paydowns exceed the five-year debt amount:

Transition year	Unreduced percentage	Reduced percentage
Year 1	5	6¼
Year 2	10	16⅔
Year 3	15	37½
Year 4	20	100

(5) *Five-year debt amount.* The "five-year debt amount" means the excess (if any) of—

(i) The amount of the outstanding indebtedness of the taxpayer on May 29, 1985, over

(ii) The amount of the outstanding indebtedness of the taxpayer on December 31, 1983. The five-year debt amount shall not exceed the aggregate amount of indebtedness of the taxpayer outstanding on November 16, 1985.

(6) *Four-year debt amount.* The "four-year debt amount" means the excess (if any) of—

(i) The amount of the outstanding indebtedness of the taxpayer on December 31, 1983, over

(ii) The amount of the outstanding indebtedness of the taxpayer on December 31, 1982.

The four-year debt amount shall not exceed the aggregate amount of indebtedness of the taxpayer outstanding on November 16, 1985, reduced by the five-year debt amount.

(7) *Paydowns.* The term "paydowns" means the excess (if any) of—

(i) The aggregate amount of indebtedness of the taxpayer outstanding on November 16, 1985, over

(ii) The limitation on the general phase-in amount described in paragraph (b)(3) of this section.

Paydowns are first applied to the five-year debt amount to the extent thereof and then to the four-year debt amount for purposes of computing the five-year and the four-year phase-in amounts.

(d) *Treatment of affiliated group.* For purposes of this section, all members of the same affiliated group of corporations (as defined in § 1.861–11(d)) shall be treated as one taxpayer whether or not such members filed a consolidated return. Interaffiliate debt is not taken into account in computing transition relief. Moreover, any reduction in the amount of interaffiliate debt is not taken into account in determining the amount of paydowns.

(e) *Mechanics of computation*—(1) *Step 1: Determination of the amounts within the various categories of debt.* Each separate member of an affiliated group must determine each of its following amounts:

(i) *November 16, 1985 amount.* The amount of its debt outstanding on November 16, 1985 (after the elimination of interaffiliate indebtedness),

(ii) *Unreduced five-year debt.* The amount of any net increase in the amount of its indebtedness on May 29, 1985 (after elimination of interaffiliate indebtedness) over the amount of its indebtedness on December 31, 1983 (after elimination of interaffiliate indebtedness),

(iii) *Unreduced four-year debt.* The amount of any net increase in the amount of its indebtedness on December 31, 1983 (after elimination of interaffiliate indebtedness) over the amount of its indebtedness on December 31, 1982 (after elimination of interaffiliate indebtedness), and

(iv) *Month-end debt.* The amount of its month-end debt level for all months after October 1985 (after elimination of interaffiliate indebtedness).

(2) *Step 2: Aggregation of the separate company amounts.* Each of the designated amounts for the separate companies identified in Step 1 must be aggregated in order to compute consolidated transition relief. Paragraph (e)(10)(iv) of this section (Step 10) requires the use of the taxpayer's current year average debt level for the purpose of computing the percentages of debt that are subject to the three sets of rules that are identified in Step 10. For use in that computation, the taxpayer should compute the current year average debt level by aggregating separate company month-end debt levels and then by averaging those aggregate amounts.

(3) *Step 3: Calculation of the lowest historic month-end debt level of the taxpayer.* In order to calculate the lowest historic month-end debt level of the taxpayer, determine the month-end debt level of each separate company for each month ending after October 1985 and aggregate these amounts on a month-by-month basis. On such aggregate basis, in any taxable year in which the taxpayer attains an aggregate new lowest historic month-end debt level, add together all the aggregate month-end debt levels within the taxable year (without taking into account any increase in aggregate debt level subsequent to the attainment of such lowest historic month-end debt level) and divide by the number of months in that taxable year, yielding the average of month-end debt levels for such year. Such average shall constitute the taxpayer's lowest historic month-end debt level for that taxable year in which the aggregate new lowest historic month-end debt level was attained. Unless otherwise specified, all subsequent references to any amount refer to the aggregate amount for all members of the same affiliated group of corporations.

(4) *Step 4: Computation of paydowns.* Paydowns equal the amount by which the November 16, 1985 amount exceeds the taxpayer's lowest historic month-end debt level, determined under Step 3.

(5) *Step 5: Computation of limitations on unreduced five-year debt and unreduced four-year debt.* (i) The unreduced five-year debt cannot exceed the November 16, 1985 amount.

(ii) The unreduced four-year debt cannot exceed the November 16, 1985 amount less the unreduced five-year debt.

(6) *Step 6: Computation of reduced five-year and reduced four-year debt*—(i) *Reduced five-year debt.* Compute the amount of reduced five-year debt by subtracting from the unreduced five-year debt (see Step 5) the amount of paydowns (see Step 4).

(ii) *Reduced four-year debt.* To the extent that the amount of paydowns (see step 4) exceeds the amount of unreduced five-year debt (see Step 5), compute the amount of reduced four-year debt by subtracting such excess from the unreduced four-year debt (see Step 1).

(iii) To the extent that paydowns do not offset either the unreduced five-year amount or the unreduced four-year amount, the reduced and the unreduced amounts are the same.

(7) *Step 7: Computation of the general phase-in amount.* The general phase-in amount is the lesser of—

(i) The percentage of the November 16, 1985 amount designated for the relevant transition year in the table below, or

(ii) The lowest group month-end debt level (see Step 3).

GENERAL PHASE-IN TABLE

Transition year	Percentage
Year 1	75
Year 2	50
Year 3	25

(8) *Step 8: Computation of Five-Year Phase-in Amount.* The five-year phase-in amount is the lesser of—

(i) The percentage of the unreduced five-year debt designated for the relevant transition year in the table below, or

(ii) The percentage of the reduced five-year debt designated for the relevant transition year in the table below.

FIVE-YEAR PHASE-IN TABLE

Transition year	Unreduced percentage	Reduced percentage
Year 1	8⅓	10
Year 2	16⅔	25

FIVE-YEAR PHASE-IN TABLE—Continued

Transition year	Unreduced percentage	Reduced percentage
Year 3	25	50
Year 4	33⅓	100
Year 5	16⅔	100

(9) *Step 9: Computation of Four-year Phase-in Amount*. The four-year phase-in amount is the lesser of—

(i) The percentage of the unreduced four-year debt designated for the relevant transition year in the table below, or

(ii) The percentage of the reduced four-year debt designated for the relevant transition year in the table below.

FOUR-YEAR PHASE-IN TABLE

Transition year	Unreduced percentage	Reduced percentage
Year 1	5	6¼
Year 2	10	16⅔
Year 3	15	37½
Year 4	20	100

(10) *Step 10: Determination of group debt ratio and application of transition relief to separate company interest expense*. (i) The general phase-in amount consists of the amount computed under Step 7. Interest expense on this amount is subject to pre-1987 rules of allocation and apportionment.

(ii) The post-1986 separate company amount consists of the sum of the amounts determined under Steps 8 and 9. Interest expense on this amount is subject to post-1986 rules of allocation and apportionment as applied on a separate company basis. Thus, §1.861–11T(c) does not apply with respect to this amount of indebtedness. Because the consolidation rule does not apply, stock in affiliated corporations shall be taken into account in computing the apportionment fractions for each separate company in the same manner as under pre-1987 rules.

(iii) The post-1986 one-taxpayer amount consists of any indebtedness that does not qualify for transition relief under Steps 7, 8, and 9. Interest expense on this amount is subject to post-1986 rules as applied on a consolidated basis.

(iv) To determine the extent to which the interest expense of each separate company is subject to any of these sets of allocation and apportionment rules, each company shall prorate its own interest expense using two fractions. The general phase-in fraction is the general phase-in amount over the current year average debt level of the affiliated group (see Step 2). The post-1986 separate company fraction is the post-1986 separate company amount over the current year average debt level of the affiliated group. The balance of each separate company's interest expense is subject to post-1986 one-taxpayer rules.

(f) *Example*. XYZ form an affiliate group.

(1) *Step 1:* Determination of the amounts within the various debt categories.

	Historic 3rd party debt	Increase
Company X:		
Nov. 16, 1985	$100,000	
May 29, 1983 (5-year)	90,000	$10,000
Dec. 31, 1983 (4-year)	80,000	10,000
Dec. 31, 1982	70,000	
Current Interest Expense	10,000	
Company Y:		
Nov. 16, 1985	200,000	
May 29, 1985 (5-year)	170,000	120,000
Dec. 31, 1983 (4-year)	50,000	10,000
Dec. 31, 1982	40,000	
Current Interest Expense	30,000	
Company Z:		
Nov. 16, 1985	300,000	
May 29, 1985 (5-year)	300,000	50,000
Dec. 31, 1983 (4-year)	250,000	100,000
Dec. 31, 1982	150,000	
Current Interest Expense	30,000	

(2) *Step 2:* Aggregation of the separate company amounts.

Aggregate Nov. 16, 1985	$600,000
Aggregate 5-year debt	180,000
Aggregate 4-year debt	120,000
Current year average debt level	700,000

(3) *Step 3:* Calculation of lowest historic month-end debt level.

An analysis of historic month-end debt levels indicates that in 1986, XYZ's aggregate month-end debt level fell to $500,000, which represents the lowest sum for all years under consideration. Because this historic low occurred in a prior tax year, there is no averaging of month-end debt levels in the current taxable year.

(4) *Step 4:* Computation of paydowns.

The aggregate November 16, 1985 amount ($600,000), less the lowest historic month-end debt level ($500,000), yields a total paydown in the amount of $100,000.

(5) *Step 5:* Computation of limitations on aggregate unreduced five-year debt and aggregate unreduced four-year debt.

Aggregate Nov. 16, 1985 amount	$600,000
Aggregate unreduced 5-year debt	180,000
Aggregate unreduced 4-year debt	120,000

Because the November 16, 1985 amount exceeds the unreduced 4- and 5-year debt, the full amount of the 4- and 5-year debt qualify for transition relief. In cases where the November 16, 1985 amount is less than the 4- or 5-year debt (or the sum of both), the latter amounts are limited to the November 16, 1985 amount. See the limitations on the 4-year and 5-year debt amounts in paragraphs (c)(6) and (c)(5), respectively, of this section.

(6) *Step 6:* Computation of reduced five-year and four-year debt. The paydowns computed under Step 4 are deemed to first offset the aggregate unreduced five-year debt. Accordingly, the reduced amount of five-year debt is $80,000. Since the paydowns are less than the aggregate unreduced five-year debt, there is no paydown in connection with aggregate unreduced four-year debt. Accordingly, the unreduced four-year debt and the reduced four-year debt are both considered to be $120,000.

(7) *Step 7:* Computation of the general phase-in amount. In transition year 1, the general transition amount is the lesser of:

(i) 75 percent of the aggregate November 16, 1985 amount (75% of $600,000 = $450,000); or

(ii) the lowest month-end debt level since November 16, 1985 ($500,000).

Therefore, the general transition amount is $450,000.

(8) *Step 8:* Computation of the five-year phase-in amount. In transition year 1, the five-year phase-in amount is the lesser of:

(i) 8⅓ percent of the unreduced five-year amount (8⅓% of $180,000 = $15,000); or

(ii) 10 percent of the reduced five-year amount (10% of $80,000 = $8,000).

Therefore, the five-year phase-in amount is $8,000.

(9) *Step 9:* Computation of the four-year phase-in amount. In transition year 1, the four-year phase-in amount is the lesser of:

(i) 5 percent of the unreduced four-year amount (5% of $120,000 = $6,000); or

(ii) 6¼ percent of the reduced four-year amount (6¼% of $120,000 = $7,500).

Therefore, the four-year phase-in amount is $6,000.

(10) *Step 10:* Determination of group debt ratio and application of relief to separate company interest expense.

(i) As determined under Step 7, interest expense on a total of $450,000 of the XYZ debt in the first transition year is computed under pre-1987 rules of allocation and apportionment.

(ii) The sum of Steps 8 ($8,000) and 9 ($6,000) is $14,000. Interest expense on a total of $14,000 of XYZ debt is computed under post-1986 rules of allocation and apportionment as applied on a separate company basis.

(iii) The balance of XYZ's current year interest expense is computed under post-1986 rules of allocation and apportionment as applied on a consolidated basis. X, Y, and Z, respectively, have current interest expense of $10,000, $30,000, and $30,000. Thus, 64.3 percent (450,000/700,000) of the interest expense of each separate company is subject to pre-1987 rules. Two percent (14,000/700,000) of the interest expense of each separate company is subject to post-1986 rules applied on a separate company basis. Finally, the balance of each separate company's current year interest expense (33.7 percent) is subject to post-1986 rules applied on a consolidated basis.

(g) *Corporate transfers*—(1) *Effect on transferee*—(i) *General rule.* Except as provided in paragraph (g)(1)(ii) of this section, if a domestic corporation or an affiliated group acquires stock in a domestic corporation that was not a member of the transferee's affiliated group before the acquisition, but becomes a member of the transferee's affiliated group after the acquisition, the transferee group shall take into account the following transition attributes of the acquired corporation in computing its transition relief:

(A) November 16, 1985 amount;

(B) Unreduced five-year amount;

(C) Unreduced four-year amount; and

(D) The amount of any transferor paydowns attributed to the acquired corporation under the rules of paragraph (h)(1) of this section.

(ii) *Special rule for year of acquisition.* To compute the amount of the transition attributes described in paragraph (g)(1)(i) of this section that a transferee takes into account in the transferee's taxable year of the acquisition, such transition attributes shall be multiplied by a fraction, the numerator of which is the number of months within the taxable year that the transferee held the acquired corporation and the denominator of which is the number of months in such taxable year. In order for the transferee to assert ownership of a subsidiary for a given month, the transferee and the acquired corporation must be affiliated corporations as of the last day of the month. In addition, the transferor and the transferee shall take account of the month-end debt level of the transferred corporation only for those months at the end of which the transferred corporation was a member of the transferor's or the transferee's respective affiliated group.

(iii) *Aggregation of transition attributes.* The transition attributes of the acquired corporation shall be aggregated with the respective amounts of the transferee group.

(iv) *Conveyance of transferor paydowns.* The total paydowns of the transferee group shall include the amount of any paydown of the transferor group that was attributed to the acquired corporation under the rules of paragraph (h)(1) of this section.

(v) *Effect of certain elections.* If an election—

(A) Is made under section 338(g) (whether or not an election under 338(h)(10) is made),

(B) Is deemed to be made under section 338(e) (other than (e)(2)), or section 338(f), or,

(C) Is made under section 336(e), no indebtedness of the acquired corporation shall qualify for transition relief for the year such election first becomes effective and for subsequent taxable years, and no other transition attributes of the acquired corporation shall be taken into account by the transferee group.

(2) *Effect on transferor*—(i) *General rule.* Except as provided in paragraph (g)(2)(ii) of this section, in the case of an acquisition of a member of an affiliated group by a nonmember of the group, the transferor shall not take into account the transition attributes of the acquired corporation in computing the transition relief of the transferor group in subsequent taxable years. Thus, the November 16, 1985 amount, the unreduced five-year and four-year debt amounts, and the end-of-month debt levels of the transferor group shall be computed without regard to the acquired corporation's respective amounts for purposes of computing transition relief of the tranferor group for years thereafter.

(ii) *Special rule for the year of disposition.* To compute the amount of the transition attributes described in paragraph (g)(2)(i) of this section that a transferor shall take into account in the transferor's taxable year of the disposition, such transition attributes shall be multiplied by a fraction, the numerator of which is the number of months within the taxable year that the transferor held the acquired corporation and the denominator of which is the number of months in such taxable year. In order for the transferor to assert ownership of a subsidiary for a given month, the transferor and the acquired corporation must be affiliated corporations as of the last day of the month.

(iii) *Effect of prior paydowns.* Any paydowns of the acquired corporation that are considered to reduce the debt of other members of the transferor group under the rules of paragraph (h)(1) of this section (whether incurred in a prior taxable year or in that portion of a year of disposition that is taken into account by the transferor) shall continue to be taken into account by the transferor group after the disposition.

(3) *Special rule for assumptions of indebtedness.* In connection with the transfer of a corporation, if the indebtedness of an acquired corporation is assumed by any party other than the transferee or another member of the transferee's affiliated group, the transition attributes of the acquired corporation shall not be taken into account in computing the transition relief of the transferee group. See paragraph (g)(2) of this section concerning

the treatment of the transferor group. Also in connection with the transfer of a corporation, if the transferee or another member of the transferee's affiliated group assumes the indebtedness of an acquired corporation, such assumed indebtedness shall only qualify for transition relief during the period in which the acquired corporation remains a member of the transferee group. Further, if the transferee group subsequently disposes of the acquired corporation, the indebtedness of the acquired corporation will continue to qualify for transition relief only if the indebtedness is assumed by the new purchaser as of the time such corporation is acquired.

(4) *Effect of asset sales.* If substantially all of the assets of a corporation are sold, the indebtedness of such corporation shall cease to be qualified for transition relief. Thus, the transition attributes of such corporation shall not be taken into account in computing transition relief.

(h) *Rules for attributing paydowns among separate companies*—(1) *General rule.* In the case of a corporate transfer under paragraph (g) of this section, it is necessary to determine the amount of paydowns attributable to the acquired corporation. Under paragraph (c)(7) of this section, paydowns are deemed to reduce first the five-year phase-in amount, then the four-year phase-in amount, and then the general phase-in amount. Thus, for example, a reduction in indebtedness of the group caused by a reduction in the debt of a group member that has no five-year debt will nevertheless be deemed under this ordering rule to reduce the indebtedness of those group members that do have five-year debt. In order to preserve the effect of paydowns caused by a reduction, each member must determine on a separate company basis at the time of any transfer of any member of the affiliated group the impact of paydowns (including those paydowns occurring in the year of transfer prior to the time of the transfer) on the various categories of indebtedness.

(2) *Mechanics of computation.* Separate company accounts of paydowns are determined by prorating any paydown among all group members with five-year debt to the extent thereof on the basis of the relative amounts of five-year debt. Paydowns in excess of five-year debt are prorated on a similar basis among all group members with four-year debt to the extent thereof on the basis of the relative amounts of four-year debt. Paydowns in excess of four-year and five-year debt are prorated among all group members with general phase-in debt to the extent thereof on the basis of the relative amounts of general phase-in debt. After an initial paydown has been prorated among the members of an affiliated group, any further reduction in the amount of aggregate month-end debt level as compared to the November 16, 1985 amount is prorated among all members of the affiliated group based on the remaining net amounts of four-year and five-year debt.

(3) *Examples.* The rules of paragraphs (g) and (h) of this section may be illustrated by the following examples.

Example 1. Computing separate company accounts of reductions. (i) *Facts.* XYZ constitutes an affiliated group of corporations that has a calendar taxable year and the following transition attributes:

	Historic 3rd party debt	Increase
Company X:		
Nov. 16, 1985	$100,000	....
May 29, 1985 (5-year)	80,000	$0
Dec. 31, 1983 (4-year)	80,000	10,000
Dec. 31, 1982	70,000	....
Company Y:		
Nov. 16, 1985	200,000	....
May 29, 1985 (5-year)	170,000	120,000
Dec. 31, 1983 (4-year)	50,000	10,000
Dec. 31, 1982	40,000	....
Company Z:		
Nov. 16, 1985	300,000	....
May 29, 1985 (5-year)	290,000	40,000
Dec. 31, 1983 (4-year)	250,000	100,000
Dec. 31, 1982	150,000	....

In 1986, the XYZ group attained its lowest historic month-end debt level of $500,000. Because the November 16, 1985 amount is $600,000 the XYZ group therefore has a paydown in the amount of $100,000. This paydown partially offsets the $160,000 of five-year debt in the XYZ group.

(ii) *Analysis.* Applying the rule of paragraph (h)(1) of this section, separate company accounts of paydowns are computed by prorating the $100,000 paydown among those members of the group that have five-year debt. Accordingly, the paydown is prorated between Y and Z as follows:

To Y:

$$\$100{,}000 \times \frac{\$120{,}000}{\$160{,}000} = \$75{,}000$$

To Z:

$$\$100{,}000 \times \frac{\$40{,}000}{\$160{,}000} = \$25{,}000$$

Example 2. Corporate acquisitions. (i) *Facts.* The facts are the same as in example 1. On July 15, 1987, the XYZ group sells all the stock of Y to A. Having held the stock of Y for six months in 1987, the XZ group computes its transition relief for that year taking into account half of the transition attributes of Y. AY constitutes an affiliated group of corporations after the acquisition. Having held the stock of Y for six months in 1987, the AY group computes its transition relief for that year taking into account half of the transition attributes of Y. In 1987, the AY group attained a new lowest month-end debt level that yields an average lowest month-end debt level for 1987 of $150,000.

(ii) *Transferee group.* The following analysis applies in determining transition relief for purposes of apportioning the interest expense of the transferee group for 1987. The AY group has the following transition attributes for 1987:

	Historic 3rd party debt	Increase
Company A:		
Nov. 16, 1985	$100,000	
May 29, 1985 (5-year)	250,000	$5,000
Dec. 31, 1983 (4-year)	245,000	10,000
Dec. 31, 1982	235,000	
Company Y (half-year amounts):		
Nov. 16, 1985	100,000	
May 29, 1985 (5-year)	85,000	60,000
Dec. 31, 1983 (4-year)	25,000	5,000
Dec. 31, 1982	20,000	
Pre-acquisition year paydown by another member of the transferor group that reduced Y's five-year debt (one half of $75,000)	37,500	

Because the November 16, 1985 amount of the AY group in 1987 is $200,000 and because the 1987 average of historic month-end debt levels was $150,000, the AY group has a paydown in the amount of $50,000. In addition, the 1986 paydown by the XYZ group that was deemed to reduce Y debt is added to the paydown computed above, yielding a total paydown of $87,500. This amount is prorated between members, eliminating the four and five year debt of the AY group. Note that Y is only a member of the AY group for half of the 1987 taxable year. In 1988, Y's entire transition indebtedness and a $75,000 paydown must be taken into account in computing the amount of interest expense eligible for transition relief.

(iii) *Transferor group.* The following analysis applies in determining transition relief for purposes of apportioning the interest expense of the transferor group for 1987. The XZ group has the transition attributes stated below for 1987. In 1987, the XZ group attained a new lowest month-end debt level that yields an average lowest month-end debt level for 1987 of $250,000.

	Historic 3rd party debt	Increase
Company X:		
Nov. 16, 1985	$100,000	
May 29, 1985 (5-year)	80,000	$0
Dec. 31, 1983 (4-year)	80,000	10,000
Dec. 31, 1982	70,000	
Pre-disposition paydown that reduced X's debt	0	
Company Y (half-year amounts):		
Nov. 16, 1985	100,000	
May 29, 1985 (5-year)	85,000	60,000
Dec. 31, 1983 (4-year)	25,000	5,000
Dec. 31, 1982	20,000	
Pre-disposition paydown that reduced Y's debt	37,500	
Company Z:		
Nov. 16, 1985	300,000	
May 29, 1985 (5-year)	290,000	40,000
Dec. 31, 1983 (4-year)	250,000	100,000
Dec. 31, 1982	150,000	
Pre-disposition paydown that reduced Z's debt	25,000	

Because the revised November 16, 1985 amount of the XZ group is $500,000 and because the 1987 average of lowest historic month-end debt levels of the XZ group was $250,000, the XZ group has a paydown in the amount of $250,000. This paydown offsets the total five and four year debt of the XZ group. Had the 1987 paydown of the XZ group been an amount less than the five-year amount, the paydown would have been prorated based on Y's adjusted 5-year amount of $22,500 and Z's adjusted 5-year amount of $15,000.

[T.D. 8257, 54 FR 31820, Aug. 2, 1989]

§ 1.861–14 Special rules for allocating and apportioning certain expenses (other than interest expense) of an affiliated group of corporations.

(a)–(c) [Reserved]. For further guidance, see § 1.861–14T(a) through (c).

(d) *Definition of affiliated group*—(1) *General rule.* For purposes of this section, the term *affiliated group* has the same meaning as is given that term by section 1504. Section 1504(a) defines an affiliated group as one or more chains of includible corporations connected through 80-percent stock ownership